

Section Three: Additional Views

A. J. Mark McWatters and Paul S. Atkins

We concur with the issuance of the February report and offer the additional observations below. We appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

There is little doubt that much uncertainty exists within the present commercial real estate, or CRE, market. Broad based recognition of CRE related losses has yet to occur, and significant problems are expected within the next two years. The bottom line is that CRE losses need to be recognized – hiding losses on balance sheets is not good for financial institutions, for investors, or for the economy. Just as in the residential real estate market, the CRE market needs freedom to engage in price discovery in order for investors to have confidence and transparency to resume investing risk capital in CRE.

In order to suggest any “solution” to the challenges currently facing the CRE market, it is critical that market participants and policymakers thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is likely that an inappropriately targeted remedy with adverse unintended consequences will result.

Broadly speaking, it appears that today’s CRE industry is faced with both an oversupply of CRE facilities *and* an undersupply of prospective tenants and purchasers. In addition to the excess CRE inventory created during the 2005-2007 bubble period, it appears that there has been an unprecedented collapse in demand for CRE property. Many potential tenants and purchasers have withdrawn from the CRE market not simply because rental rates or purchase prices are too high, but because their business operations do not presently require additional CRE facilities. Over the past few years while CRE developers have constructed a surplus of new office buildings, hotels, multi-family housing, retail and shopping centers, and manufacturing and industrial parks, a significant number of end users of such facilities have suffered the worst economic downturn in several generations. Any posited solution to the CRE problem that focuses only on the oversupply of CRE facilities to the exclusion of the economic difficulties facing the end users of such facilities appears unlikely to succeed. The challenges confronting the CRE market are not unique to that industry, but, instead, are generally indicative of the systemic uncertainties manifest throughout the larger economy.

In order to address the oversupply of CRE facilities, developers and their creditors are currently struggling to restructure and refinance their CRE portfolio loans. In some instances creditors with sufficient regulatory capital are acknowledging economic reality and writing their loans down to market value with, perhaps, the retention of an equity participation right. In other cases lenders are merely “kicking the can down the road” by refinancing problematic credits on

favorable terms at or near par so as to avoid the recognition of book losses and the attendant reductions in regulatory capital. With respect to the most problematic credits, lenders are foreclosing on their CRE collateral interests and are either attempting to manage the properties in a depressed market or disposing of the facilities at significant discounts. While these approaches may offer assistance in specifically tailored instances, none directly addresses the challenge of too few tenants and purchasers of CRE facilities.

Until small and large businesses regain the confidence to hire new employees and expand their business operations, it remains doubtful that the CRE market will sustain a meaningful recovery. As long as businesses are faced with the multiple challenges of rising taxes, increasing regulatory burdens, and enhanced political risk associated with unpredictable governmental interventions in the private sector (including government actions that will affect health care and energy costs), it is unlikely that they will enthusiastically assume the entrepreneurial risk necessary for protracted business expansion at the micro-economic level and thus a recovery of the CRE market at the macro-economic level. It is fundamental to acknowledge that the American economy grows one job and one consumer purchase at a time, and that the CRE market will recover one lease, one sale, and one financing at a time. With the ever-expanding array of less-than-friendly rules, regulations and taxes facing businesses and consumers, we should not be surprised if businesses remain reluctant to hire new employees, consumers remain cautious about spending, and the CRE market continues to struggle.

It is indeed ironic that while Treasury is contemplating a plan to fund another round of TARP-sourced allocations for “small” financial institutions (including targeting funds to certain favored groups, including CDFIs), the Administration is also developing a plan to raise the taxes and increase the regulatory burden of many financial institutions and other CRE market participants. The Administration seems reluctant to acknowledge that such actions may raise the cost of capital to such financial institutions and decrease their ability to extend credit to qualified CRE and other borrowers. More significantly, the Administration appears indifferent to the dramatic level of uncertainty that such actions have injected into an already unsettled marketplace.

It is also troublesome that Treasury would contemplate another round of bailouts to rescue financial institutions that placed risky bets on the CRE market. Over the years many of these institutions have profited handsomely by extending credit to CRE developers, and it is disconcerting that these same institutions and their CRE borrowers would approach the taxpayers for a bailout. We should also note that during the bubble era, these institutions and the CRE developers were almost assuredly managed by financial and real estate experts and advised by competent counsel and other professionals who were thoroughly versed in the risks associated with CRE lending and development.⁵⁶⁰

⁵⁶⁰ Sophisticated securities products, including CDSs, also were developed to provide for hedging and risk management for CRE and CMBS exposure, among other things. Some have mistakenly likened these products to

Although some financial institutions may struggle or even fail as a result of their ill-advised underwriting decisions and the resulting overdevelopment of the CRE market, any taxpayer-funded bailouts of these institutions will inject unwarranted moral hazard risk into the market and all but establish the United States government as the implicit guarantor of any future losses arising from distressed CRE loans.⁵⁶¹ Such actions will also encourage private sector participants to engage in less-than-prudent economic behavior, confident in the expectation--if not an emerging sense of entitlement--that the taxpayers will yet again offer a bailout if their CRE portfolios materially underperform. Since CRE market participants reaped the benefits from the run-up to the CRE bubble, they should equally shoulder the burdens from the bursting of the bubble. The Administration—through TARP, a program similar to the Resolution Trust Corporation (RTC),⁵⁶² or otherwise — should not force the taxpayers to subsidize these losses and underwrite the poor management decisions and analysis of such CRE lenders and developers. A market economy by necessity must cull or marginalize the products and services of the weakest participants so that those who have developed innovative and competitive ideas may prosper on a level playing field. Any attempt by the Administration to prop-up the financial institutions and developers who contributed to the oversupply of CRE property is not in the best interests of the more prescient and creative market participants or the taxpayers. The opportunity for entrepreneurs to succeed or fail based upon their own acumen and judgment must survive the current recession and the implementation of the TARP program.

In addition, as the Report notes, Treasury has realized that financial institutions increasingly consider TARP to be a stigma of weakness. This perception is inevitable after almost a year and a half of TARP and is a healthy development. In fact, banks that accept TARP funds at this point of the economic cycle should be branded as weaker institutions. A question for policymakers is whether they should be allowed to fail rather than be propped up further at taxpayer expense.

—insurance,” because some market participants viewed them in that sort of role. It is a facile comparison, because they differ in significant ways from —insurance.” Thus, they properly are not treated as such.

⁵⁶¹ The results of any additional —stress tests” conducted by the applicable banking supervisors should not be used by Treasury as an excuse for the allocation of additional TARP funds to capital-deficient financial institutions. Instead, such financial institutions should seek capital from the private markets or be liquidated or sold through the typical FDIC resolution process.

⁵⁶² The RTC responded to the failure of a significant number of financial institutions within specific geographic areas. Without the RTC, some have argued that the affected areas would have been “materially under-banked.” It is not apparent that the same situation manifests itself today as a result of distressed CRE loans or otherwise. Some banks will fail (and will be liquidated or sold through the typical FDIC resolution process), but a substantial majority should survive and will be better off by not having to compete with their mismanaged former peers. Because these banks are not systemically significant financial institutions, the failure of which might materially impair the U.S. economy, Treasury’s potential use of the TARP program to recapitalize them stretches the intent of EESA and would create risks of moral hazard and implicit government guarantees. In addition, an RTC-type approach raises the potential for unintended enrichment of some participants at the taxpayer’s expense.

Finally, as Treasury considers its actions in using TARP funds in the context of CRE or other areas, it must be mindful not only of political realities, but also funding realities. As the Report indicates, there are substantial —~~un~~committed” funds available to Treasury under the TARP. Some of these funds have never been allocated out of Congress’s original authorization of \$700 billion under EESA. However, if Treasury exceeds the original \$700 billion in total allocations under the TARP, it then would rely on its interpretation that EESA allows ~~re~~“recycling” of TARP funds; that is, amounts returned to the Treasury create more ~~headroom~~” for Treasury to use TARP funds up to a maximum outstanding *at any time* of \$700 billion. We find Treasury’s legal analysis regarding this interpretation of EESA unconvincing and disagree with Treasury’s assertion that these returned amounts become ~~un~~committed” funds again, which may be re-committed.